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In the Supreme Court of the United States

OCTOBER TERM, 1978

UNITED CALIFORNIA BANK and LILLIAN DISNEY TRUYENS, CO-EXECUTORS OF THE ESTATE OF WALTER E. DISNEY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes involved	2
Statement	2
Summary of argument	10
Argument	15
The alternative capital gains tax computation by an estate under Section 1201(b) of the Internal Revenue Code precludes a deduction from long-term capital gains for the amount of such gains set aside by the estate for charity	15
A. The language and legislative history of Section 1201(b) demonstrate that net long-term capital gains are subject to the preferential flat rate without reduction for amounts otherwise deductible against ordinary income	15
1. The language of the statute	17
2. The legislative history	26
B. There is no exception for estates or trusts from the rule of Section 1201(b) that net long-term capital gains are subject to tax without reduction for amounts set aside for charity	32
Conclusion	47
Appendix	1a

CITATIONS

Cases: Page

Better Business Bureau v. *United States*, 326 U.S. 279 47
Central Tablet Mfg. Co. v. *United States*, 417 U.S. 673 43
Chartier Real Estate Co. v. *Commissioner*, 52 T.C. 346, affirmed, 428 F.2d 474 ..... 12, 16, 32
Commissioner v. *Gordon*, 391 U.S. 83 47
Commissioner v. *Korell*, 339 U.S. 619 22
Commissioner v. *Nat. Alfalfa Dehydrating*, 417 U.S. 134 43
Crane v. *Commissioner*, 331 U.S. 1 ..... 11, 22
Frank Lyon Co. v. *United States*, No. 76-624, decided April 18, 1978 43
Freuler v. *Helvering*, 291 U.S. 35 34
Goodwin v. *United States*, 458 F.2d 108 41
Hanover Bank v. *Commissioner*, 369 U.S. 672 22
Helvering v. *Bliss*, 293 U.S. 144 46
Malat v. *Riddell*, 383 U.S. 569 22
Meissner v. *United States*, 364 F.2d 409 41
Pope & Talbot, Inc. v. *Commissioner*, 60 T.C. 74, affirmed, 515 F.2d 155 32
Quick v. *United States*, 503 F.2d 100 41
Read v. *United States*, 320 F.2d 550 41
Sidles, Estate of v. *Commissioner*, 65 T.C. 873, acq. 1976-2 Cum. Bull. 2 41
Statler Trust v. *Commissioner*, 361 F.2d 128 ..... 9, 13, 16, 25, 35, 44
United States v. *Benedict*, 338 U.S. 692 6
United States v. *Consumer Life Ins. Co.*, 430 U.S. 725 22

Cases—Continued Page

United States v. *Foster Lumber Co.*, 429 U.S. 32 ..... 11, 16, 22, 24, 25, 46
Weil v. *Commissioner*, 23 T.C. 424, affirmed, 229 F.2d 593 ..... 12, 16, 31, 32, 44

Statutes and regulations:

Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)):
Section 117(c) 29, 30
Section 117(c)(2) 31
Internal Revenue Code of 1954 (26 U.S.C. (1964 ed.)):
Section 1 18
Section 63(a) 18, 22, 24
Section 170(c)(2) 3
Section 172(b)(2) 22, 23
Section 501(c)(3) 3
Section 511 18
Section 641 18
Sections 641-691 34
Section 642(c) 2, 14, 33, 36, 37, 40, 1a
Section 642(c)(4) 6, 8
Section 643(a) 2, 34, 2a
Section 643(a)(1)-(a)(7) 38
Section 643(a)(3) 14, 15, 38, 39, 44
Section 651 37
Section 652 40
Section 661 ..... 13, 34, 35, 37, 38, 40, 5a
Section 661(a) 2, 14, 35, 5a
Section 661(a)(1) 41
Section 662 ..... 2, 34, 35, 37, 38, 40, 5a

Statutes and regulations—Continued	Page
Section 662(a)	35, 5a
Section 662(a)(1)	40, 44, 6a
Section 662(a)(2)	41, 6a
Section 662(b)	35, 41
Section 663(a)(2)	2, 13, 35, 36, 37, 8a
Section 691(c)	41, 42, 43
Section 1201	2, 3, 6, 15, 16, 26, 28, 29, 30
Section 1201(a)	17, 32
Section 1201(b)	*passim*
Section 1201(b)(1)	19, 21, 24, 25
Section 1201(b)(2)	5, 11, 12, 21, 22, 24, 25, 42
Section 1202	2, 3, 5, 10, 15, 18, 19, 20, 21, 24, 40, 9a
Revenue Act of 1921, 42 Stat. 227	26
Section 206(a)(4)	26
Section 206(a)(5)	26
Section 206(b)	26
Revenue Act of 1924, Section 208(a)(5), 43 Stat. 262	12, 26
Revenue Act of 1926, Section 208(a)(5), 44 Stat. 19	27
Revenue Act of 1928, Section 101(c)(5), 45 Stat. 811	27
Revenue Act of 1932, Section 101(c)(5), 47 Stat. 191	27
Revenue Act of 1934, Section 117(a), 48 Stat. 714	27
Revenue Act of 1938, 52 Stat. 500-501:	
Section 117(a)(8)	28
Section 117(b)	28
Section 117(c)	28
Section 117(c)(1)	28

Statutes and regulations—Continued	Page
Treasury Regulations on Income Tax (26 C.F.R.):	
Section 1.643(a)-3(a)	38
Section 1.662(a)-2	40
Section 1.662(a)-2(e)	40
Section 1.662(b)-2	41
Section 1.1202-1(b)	40
Miscellaneous:	
H.R. 9662, 86th Cong., 2d Sess. (1960)	37
H.R. Rep. No. 179, 68th Cong., 1st Sess. (1924)	27
H.R. Rep. No. 1231, 86th Cong., 2d Sess. (1960)	37
H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954)	29
H.R. Rep. No. 2330, 75th Cong., 3d Sess. (1938)	29
Rev. Rul. 56-247, 1956-1 Cum. Bull. 383	31
S. Rep. No. 1622, 83d Cong., 2d Sess. (1954)	29

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OPINIONS BELOW

The findings of fact and conclusions of law of the district court (A. 54-56) are not officially reported. The opinion of the court of appeals (Pet. App. 4-15)[1] is reported at 563 F.2d 400.

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[1] There is a typographical error in the reproduction of an example in the court of appeals' opinion in the third sentence at Pet. App. 7. That sentence should read: "Assume further that in 1967 the estate realized and recognized $50,000 in ordinary income and $500,000 consisting of long-term capital gains." See 563 F.2d at 402.

JURISDICTION

The judgment of the court of appeals was entered on October 21, 1977, as of October 19, 1977 (A. 4-5). The petition for a writ of certiorari was filed on January 17, 1978, and was granted on March 20, 1978. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the alternative capital gains tax computation by an estate under Section 1201(b) of the Internal Revenue Code of 1954 precludes a deduction from long-term capital gains for the amount of such gains set aside by the estate for charity.

STATUTES INVOLVED

The pertinent provisions of Sections 642(c), 643(a), 661(a), 662, 663(a)(2), 1201(b), and 1202 of the Internal Revenue Code of 1954, as amended (26 U.S.C., 1964 ed.), are set forth in the Appendix, *infra*. pp. 1a-9a.

STATEMENT

1. Petitioners are the co-executors of Walter E. Disney, who died on December 16, 1966. By his will, Disney left 45 percent of the residue of his estate to the Disney Foundation, in trust for the Foundation, and for the California Institute of the Arts. During 1967 and 1968, the years in question, the Foundation, the Institute, and the trust created by the will under which the Foundation is trustee, were qualified charitable organizations within the meaning of Sections 170(c)(2) and 501(c)(3) of the Internal Revenue Code of 1954 (Stip. of Facts, ¶¶ 1, 2, A. 6).

In 1967 and 1968, petitioners sold certain securities included in the residue of the estate and realized net long-term capital gains of $500,622.38 and $1,058,018.43, respectively. The estate incurred no short-term capital losses during those years. In 1967, the estate realized a net short-term capital gain of $16,944.16. Pursuant to the terms of Disney's will, petitioners set aside 45 percent of the net long-term capital gains, as part of the residue of the estate, to the Foundation, as trustee for the Foundation and the Institute (Stip. of Facts, ¶¶ 4, 5, A. 7).

For the years in question, the Internal Revenue Code prescribed two methods for the computation of the tax on the capital gains of non-corporate taxpayers, *viz.*, the "normal" and "alternative" methods respectively imposed by Sections 1202 and 1201. Under the normal method, the taxpayer deducts from his gross income an amount equal to 50 percent of the excess of net long-term capital gains over net short-term capital losses. After subtraction of other deductible items, the resulting figure (taxable income) is taxed at the ordinary graduated rates.

The alternative method is applicable only if it produces a lower tax liability than the normal method. For non-corporate taxpayers such as the Disney Estate, the alternative method of Section 1201(b) involves a two-step process. First, a partial tax is com-

puted at the ordinary rates on the taxable income (as computed above), reduced by the remaining 50 percent of the excess of the net long-term capital gains over the net short-term capital losses (step 1). Second, a 25 percent tax is imposed on the excess of the net long-term capital gains over the net short-term capital losses (step 2). The alternative tax is the sum of these two computations.

In the fiduciary income tax returns filed by petitioners on behalf of the estate for 1967 and 1968, petitioners claimed the benefit of the alternative method of computing the capital gains tax (Stip. of Facts, ¶ 6, A. 7; Exs. B, D, A. 35, 48). In computing the tax under the alternative method, petitioners first deducted from taxable income an amount equal to 50 percent of the remaining long-term capital gains from which the amount of such gains set aside for charity had been excluded (step 1); they also deducted the amount set aside for charity from the net long-term capital gains subject to the flat 25 percent tax (step 2). Petitioners' alternative tax computation resulted in a lower tax under the alternative method than under the normal method (Ex. B, pp. 1, 4, A. 35).

On audit, the Commissioner of Internal Revenue determined that petitioners' alternative tax computation was erroneous insofar as it deducted the amount set aside for charity from the net long-term capital gains base subject to the flat 25 percent tax. The Commissioner based his determination on the fact that

Section 1201(b)(2) does not permit any deduction from the capital gains tax base because it defines that base as "an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss." He therefore disallowed petitioners' claimed charitable deductions from the capital gains base. These adjustments resulted in an alternative tax liability greater than that produced under the normal method for each of the years in question. The Commissioner therefore concluded that petitioners should have employed the normal method of computing the estate's capital gains tax and accordingly issued assessments against the estate (Stip. of Facts, ¶ 8, A. 8).

2. The controversy between the parties concerning the correct interpretation of the statute may be illustrated by setting forth the figures for one of the two years at issue. There is no dispute with respect to the computation of the estate's Section 1202 normal tax. Using the figures for 1967, rounded off for purposes of illustration, the normal tax would be computed as follows:

Normal Tax

Estate gross income, including long-term capital gain of $500,000		$595,000
Less:	Charitable deduction	($145,000) [2]
	Section 1202 deduction (50 percent of $500,000 excess of long-term capital gains over short-term capital losses)	($250,000)
	Miscellaneous deductions	($95,000) 54,000
Estate Taxable Income		$146,000
Tax (regular rates)		$88,000

The dispute between the parties involves the computation of the Section 1201(b) alternative tax. Petioners' and the Commissioner's methods of computation for 1967 are respectively as follows:

Alternative Tax Computations

A. *Petitioners' Method*

1. Estate taxable income		$146,000
Less:	50 percent reduction of "excess" of net long-term capital gain over net short-term capital loss under Section 1201(b)(1)	($137,500)

[2] Although the estate set aside $225,000 (45 percent of $500,000 long-term capital gain), Section 642(c)(4) requires that this amount be adjusted to take into account the Section 1202 deduction and thereby prevent a double deduction. Section 642(c)(4) codified this Court's decision in *United States* v. *Benedict*, 338 U.S. 692. Thus, the estate was permitted a charitable deduction of only one-half of the $225,000 or $112,500, since the other half is included in the Section 1202 deduction. The remaining amount ($32,500) of the $145,000 charitable deduction was attributable to short-term capital gain and ordinary income set aside for charitable legatees.

	Petitioners computed this "excess" by reducing the long-term capital gain of $500,000 by the 45 percent paid to charity (or $225,000), leaving a balance of $275,000 (50 percent of $275,000=$137,500)	
	Partial taxable income	$8,500
	Tax (at normal rates) on partial taxable income	$1,800
	plus	
2.	Tax on long-term capital gain (25 percent x $275,000) under Section 1201(b)(2))	$69,000
	Total tax	$70,800

B. *The Commissioner's Method*

1. Estate taxable income		$146,000
Less:	50 percent reduction of "excess" of net long-term capital gain over net short-term capital loss under Section 1201(b)(1)	($250,000)
	This "excess" represents the entire $500,000 of long-term capital gain unreduced by the amounts set aside for charity	
	Partial taxable income	-0-
	Tax (at normal rates) on partial taxable income	-0-
	plus	
2.	Tax on long-term capital gain (25 percent of $500,000) under Section 1201(b)(2)	$125,000
	Total tax	$125,000

The foregoing computations illustrate the critical point of difference between the parties. Under petitioners' method of computing the alternative tax, the $500,000 long-term capital gain is reduced by the estate's set-aside to charity in the second step of the computation so as to decrease the capital gains subject to the flat 25 percent rate. That approach resulted in an alternative tax ($70,800) that was less than the normal tax ($88,000). However, under the Commissioner's method, the amount set aside for charity does not reduce the net long-term capital gains subject to the 25 percent rate. The Commissioner's method resulted in a normal tax ($88,000) that was less than the alternative tax ($125,000).[3]

The Commissioner's disallowances resulted in assessments for additional taxes against the estate for 1967 and 1968.[4] After paying the additional assessments, petitioners brought this refund suit in the United States District Court for the Central District of California.

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[3] Petitioners excluded from the alternative tax computation $225,280.07 and $476,108.30 from net long-term capital gains for 1967 and 1968, respectively (Ex. p. 4, A. 34; Ex. D, p. 1 Schedule D, p. 2, A. 48). However, the Commissioner allowed charitable deductions for those years of $144,738.96 and $352,335.01 under Section 642(c)(4) only under the normal tax computation. See also p. 6, n. 2, *supra*.

[4] The situation is the same for 1968, except that the dollar difference between the parties is larger. For that year, the normal tax was $189,000. The alternative tax was $146,000 under petitioners' method and $265,000 under the Commissioner's method.

The district court upheld petitioners' claim on the authority of the majority opinion in *Statler Trust* v. *Commissioner*, 361 F.2d 128 (C.A. 2) (A. 54-56). It ruled that amounts of long-term capital gain set aside by the estate for charity may be deducted in computing " 'the excess of the net long-term capital gain over the net short-term capital loss' " under the Section 1201(b) alternative tax (A. 55).

The court of appeals unanimously reversed (Pet. App. 4-15). As it viewed the matter, "[t]he Code could be drafted in a manner that would conform to the taxpayer's wishes. Unfortunately, it is not so written" (Pet. App. 9). It concluded that "the proper course is to follow closely the Code's precise language" and therefore "interpret[ed] section 1201(b), which describes the method by which the alternative tax is to be computed, precisely as it is written" (Pet. App. 12). Since the statutory term—"the excess of the net long-term capital gain over the net short-term capital loss"—does not authorize any deduction for amounts distributed to or set aside for charity, the court of appeals rejected petitioners' claimed charitable deduction in the context of the alternative tax computation (*ibid.*). In so holding, the court was persuaded by the analysis of the dissenting judge in *Statler Trust* v. *Commissioner*, *supra*, 361 F.2d at 133, who stated: "The statute's effect is too plain to be supposed an inadvertent one, and it is far from being ungenerous. The alternatives are payment of tax at ordinary rates on half the capital gain less the adjusted deduction for the part of it paid to charity or paying a tax on

that same income amount equal to a quarter of the total capital gain" (Pet. App. 14).

SUMMARY OF ARGUMENT

A.

There are two methods of computing the tax on long-term capital gains for a non-corporate taxpayer. Under the so-called "normal" method of Section 1202 of the Internal Revenue Code of 1954, the taxpayer includes the net long-term capital gain in gross income and then deducts 50 percent of the net long-term capital gains.[8] The resulting figure (taxable income) is taxed at the ordinary graduated rates. Section 1201 (b) prescribes an "alternative" tax, calculated in two steps and applied when resulting in a lower tax liability than the normal method. The first step computes a partial tax at the ordinary rates on the taxable income reduced by the remaining 50 percent of the net long-term capital gain. This step effectively removes the net long-term capital gain from the computation, and subjects the remaining income to the partial tax at progressive rates. The second step imposes a 25 percent tax on the net long-term capital gain. The alternative tax is the sum of the partial tax and the 25 percent tax.

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[8] Petitioners incurred no net short-term capital losses during the years in question. Hence, for purposes of simplicity, we use the term "net long-term capital gain" rather than the statutory equation "excess" of "net long-term capital gain" over "net short-term capital loss."

1. The court of appeals correctly held that petitioners, who are executors of an estate which earned long-term capital gains, could not offset the alternative capital gains tax base by the amount of such gains set aside for charity. The plain language of Section 1201(b)(2), which imposes a 25 percent tax on "the excess of the net long-term capital gain over the net short-term capital loss," can only mean the total long-term capital gains unreduced by any offset. For petitioners to prevail, the statutory "excess" phrase would have to be given a unique meaning applicable only to the alternative tax computation, *i.e.*, "excess * * * reduced by the amount of such net long-term gain set aside for charity." Such a radical transformation of Section 1201(b)(2) hardly comports with this Court's oft-stated admonition that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner*, 331 U.S. 1, 6.

Indeed, in *United States* v. *Foster Lumber Co.*, 429 U.S. 32, the Court recently rejected a similar attempt by a taxpayer to depart from the plain meaning of a tax statute and to impose a special gloss only with respect to the alternative tax computation. The reasoning of *Foster Lumber Co.* should govern this case. Just as the Court refused to rewrite the statute to accommodate the special needs of a taxpayer required to employ the alternative tax computation, it should likewise refuse to cumulate the benefits of the alternative tax and the ordinary income deductions by inter-

polating a charitable contribution deduction in Section 1201(b)(2). If Congress had intended to allow a deduction from the capital gains tax base for the amount of such gains set aside for charity, it could easily have done so in plain unmistakable terms.

2. The legislative history confirms that Congress intended that the Section 1201(b)(2) capital gains tax base was not to be offset by deductions. Section 208(a)(5) of the Revenue Act of 1924 provided that under the alternative method a taxpayer could offset his capital gains base by the amount by which his ordinary deductions exceeded his ordinary income. The Revenue Act of 1934 changed the method of treating long-term capital gains and eliminated the alternative tax. But when Congress reintroduced the alternative tax computation in the Revenue Act of 1938, it redefined the capital gains base as the total net long-term capital gain without any further offset. The legislative evidence therefore clearly establishes that Congress previously accepted but has now deliberately rejected the computational method urged by petitioners in this case. There is accordingly no basis for engrafting the once-applicable provisions of the Revenue Act of 1924 back onto the present statute. Accord: *Weil* v. *Commissioner*, 23 T.C. 424, affirmed, 229 F.2d 593 (C.A. 6); *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346, 350-356 (Raum, J.), affirmed *per curiam*, 428 F.2d 474 (C.A. 1).

B.

Petitioners premise their claim to a charitable deduction offset entirely on the ground that an estate rather than an individual earned the capital gains in question and that estates are subject to special "conduit" rules that override the otherwise applicable requirements of the alternative tax computation. In petitioners' view, the Code considers an estate to be a "conduit" with respect to the portion of its capital gains set aside for charity, and from the very outset such gains are attributable to the charitable beneficiaries and not to the estate. They accordingly conclude that such gains can be excluded from the Section 1201(b) tax base. In support of their argument, petitioners rely upon *Statler Trust* v. *Commissioner*, 361 F.2d 128 (C.A. 2). There, although the Court acknowledged that the language of Section 1201(b) supported the government's position, it employed a conduit rationale, concluding that "the letter of § 1201 (b) must yield when it would lead to an unfair and unintended result" (361 F.2d at 131).

Contrary to the conclusion of the Second Circuit, the result is neither unfair nor unintended. The pertinent provisions of the Code effectively refute petitioners' and *Statler Trust's* assumption that capital gains set aside by an estate for charity are subject to the conduit rules under which such gains would be deductible by the estate under Section 661 as distributions of income required to be distributed currently. Section 663(a)(2) provides an explicit statutory rule

that amounts qualifying for the charitable deduction are not to be taken into account in computing an estate's distribution deduction under Section 661(a). Indeed, the fact that Section 642(c) allows an estate or trust a deduction from gross income for amounts set aside for charity shows that Congress classified such amounts as belonging to the estate or trust in the first instance and not to the charitable beneficiary.

Nor does Section 643(a)(3) support petitioners' conduit argument with respect to charitable contributions. The function of that provision is to assure that capital gains that will give rise to a charitable deduction, if set aside for charity, will be included in "distributable net income"—the maximum amount upon which the beneficiaries can be taxed. Absent such an "add-back" provision, the estate's distributable net income (which already has been reduced by the charitable contribution deduction) would not include the amount of the capital gains set aside for charity and the other current income beneficiaries would thereby be able to receive tax-free distributions to the extent of those gains.

Thus, contrary to the view of the Second Circuit in *Statler Trust*, the purpose of Section 643(a)(3) was not to subject charitable contributions to conduit treatment, but instead was to deny the benefits of the charitable deduction to other current income beneficiaries of the estate. As the court below correctly observed (Pet. App. 15), "The [*Statler Trust*] court's reliance on section 643(a)(3)'s inclusion of charitable

payments and set asides from capital gains in distributable net income to evidence a pervasive reliance on a conduit principle for such charitable provisions is misplaced. Section 643(a)(3) * * * is part of a structure which in its entirety unmistakably rejects the conduit principle for charitable payments and set asides."

ARGUMENT

THE ALTERNATIVE CAPITAL GAINS TAX COMPUTATION BY AN ESTATE UNDER SECTION 1201(b) OF THE INTERNAL REVENUE CODE PRECLUDES A DEDUCTION FROM LONG-TERM CAPITAL GAINS FOR THE AMOUNT OF SUCH GAINS SET ASIDE BY THE ESTATE FOR CHARITY

A. The language and legislative history of Section 1201(b) demonstrate that net long-term capital gains are subject to the preferential flat rate without reduction for amounts otherwise deductible against ordinary income

The question presented in this federal income tax case is technical and computational in character. It involves the operation of the provisions of the Internal Revenue Code governing the taxation of capital gains under both the "normal" (Section 1202) and the "alternative" (Section 1201) methods. These are two discrete methods for the computation of the tax on capital gains, and the Code requires that the computation producing the lesser liability be applicable. The normal method of Section 1202 has been applied without disagreement and is not the subject of the dispute in this case. However, the courts of appeals have

divided on the question of the correct amount of the Section 1201 alternative tax liability of a trust or estate that sets aside part of its long-term capital gains for charity.

The decision below held, in conformity with the analogous decisions involving an individual taxpayer in *Weil* v. *Commissioner*, 23 T.C. 424, affirmed, 229 F.2d 593 (C.A. 6), and a corporate taxpayer in *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346, 350-356 (Raum, J.), affirmed *per curiam*, 428 F.2d 474 (C.A. 1),[6] that the long-term capital gains base subject to the preferential flat 25 percent rate in the alternative tax computation could not be reduced by amounts otherwise deductible against ordinary income. It therefore concluded that petitioners, who are executors of an estate,[7] could not, in the alternative computation, reduce the estate's long-term capital gains by the amount of such gains set aside for charity pursuant to the terms of the will. In so ruling, the court rejected the contrary decision of the Second Circuit in *Statler Trust* v. *Commissioner*, 361 F.2d 128.

We submit that the court below correctly held that the net long-term capital gains base cannot be

[6] The second issue in *Chartier Real Estate Co.*, involving the amount of a loss carryover available after a carryback to a year in which the alternative tax was applicable, was resolved in favor of the government by this Court's decision in *United States* v. *Foster Lumber Co.*, 429 U.S. 32.

[7] We use the term "petitioners" to refer to the Disney Estate.

offset by a charitable contribution deduction under the alternative tax computation. Both the language of the statute and its legislative history confirm that Congress intended that net long-term capital gains were to be fully subject to the alternative 25 percent tax without any reduction for amounts that would be deductible in the regular computation of taxable income. Indeed, as we shall show, the structure of the statute demonstrates that such deductions (such as the deduction for charitable contributions) come into play only when the ordinary progressive rates are applied against the resulting tax base. But under the alternative tax computation, the net long-term capital gains base is not subject to the progressive rates but to a preferential flat 25 percent rate that is designed to operate as an upper limit on the taxation of such gains. That flat rate is an alternative benefit that cannot be claimed in tandem with the deductions available when the tax at ordinary rates is applicable. Hence, there is no justification for petitioners' attempt to reduce the base upon which the preferential rate is imposed and thereby cumulate the benefits of the charitable contribution deduction and the alternative tax.

1. *The language of the statute*

a. As indicated *supra*, pp. 3-4, the Internal Revenue Code provides noncorporate taxpayers with two methods of computing the tax on capital gains.[8] Under

[8] There is also an alternative tax computation for corporations provided by Section 1201(a).

the normal method of Section 1202, the taxpayer is permitted a deduction from gross income equal to 50 percent of the net long-term capital gains.[9] After further subtraction of "the [other] deductions allowed by this chapter" to arrive at "taxable income" as defined by Section 63(a), the resulting figure is subject to tax at the regular progressive rates.

Section 1201(b) prescribes an alternative tax for non-corporate taxpayers on the excess of the net long-term capital gains over the net short-term capital losses. This alternative tax is an exception to the graduated income tax imposed by Sections 1 and 641 of the Code upon non-corporate taxpayers such as individuals, estates, and trusts. As Section 1201(b) provides, the alternative tax is "in lieu of the tax imposed by sections 1 and 511, * * * (if such tax is less than the tax imposed by such sections)." Thus, if a taxpayer has income from capital gains, he is required to compute his tax under both Sections 1 and 1201 (b) and employ whichever method yields the lower liability.

The mechanics of the Section 1201(b) alternative tax computation involve a two-step process. Section 1201(b) provides that the alternative tax is the sum of—

> (1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of [the excess of the net long-term capital gain over the net short-term capital loss], at the rate

[9] See p. 10, n. 5, *supra*.

> and in the manner as if this subsection had not been enacted, and
>
> (2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Under the first step of the statutory formula, a partial tax is computed on the taxable income reduced by 50 percent of the net long-term capital gains [10] at the regular rates imposed by Section 1. Since the taxable income already reflects the Section 1202 deduction of 50 percent of net long-term capital gains available under Section 1202, the consequence of the second 50 percent deduction is effectively to exclude the net long-term capital gains from the computation of the partial tax.[11] The alternative tax is the sum of the partial tax and the 25 percent tax on long-term capital gains. Thus, if a taxpayer had net long-term capital gains sufficient to subject part of his income to tax at incremental rates greater than 50 percent under the regular computation, he would be required to use the alternative tax.

In this case, it is undisputed that petitioners' taxable income for 1967 was approximately $146,000 (see

[10] See p. 10, n. 5, *supra*.

[11] Strictly speaking, the Section 1201(b)(1) "partial" tax base is taxable income less 50 percent of the excess of net long-term capital gains over net short-term capital losses. That base would therefore include net short-term capital gains for 1966 and only a small amount ($16,944.16) for 1967, we have for convenience referred to the Section 1201(b)(1) partial tax base as "net ordinary income."

• However, because petitioner had no short-term capital gains

p. 6, *supra;* Ex. B, p. 1, A. 35). This figure represents petitioners' gross income of $595,000 (including $500,000 of long-term capital gains) minus allowable deductions, including the charitable contribution deduction and the Section 1202 deduction equal to 50 percent of their net long-term capital gains ($500,000 divided by 2 = $250,000). However, when petitioners computed their tax liability under the alternative method, they turned about and adopted an entirely different assumption with respect to the treatment of their long-term capital gains. For these purposes, petitioners assumed that they had only $275,000 of long-term capital gains, *i.e.*, the difference between $500,000 and the $225,000 of such gains set aside for charity. In petitioners' view, they never received the $225,000 that was set aside for charity pursuant to the terms of Disney's will. As a result, in computing the partial tax base under step 1 of the alternative method, petitioners reduced their $146,000 taxable income (which already reflected the allowable charitable contribution deduction) by a 50 percent deduction of $137,500 (($500,000 minus $225,000) divided by 2). This computation resulted in a partial tax base of $8,500 ($146,000 minus $137,500). Moreover, they claimed that the amount of long-term capital gain subject to the 25 percent flat rate was $275,000 ($500,000 minus $225,000), rather than $500,000.

But the language of the statute does not permit such varying assumptions as to the includability of long-term capital gains. To the contrary, it provides

a uniform verbal formula for the computation of long-term capital gains that is unaffected by the amount of such gains set aside for charity, or, indeed, any other deduction that might otherwise be available as an offset against income. Sections 1202, 1201 (b) (1) and 1201 (b) (2) all speak of the "excess of the net long-term capital gain over the net short-term capital loss."[12] Thus, for any given taxable year, that statutory element is a constant that does not vary in accordance with whether the taxpayer is computing the normal tax with the Section 1202 deduction, or the alternative tax as the sum of the partial tax and the flat 25 percent tax on long-term capital gains. For 1967, the statutory "excess of the net long-term capital gain over the net short-term capital loss" for all purposes is therefore $500,000, and not $500,000 minus $225,000, as petitioners would have it.

b. Moreover, the statutory phrase "excess of the net long-term capital gain over the net short-term capital loss" is not susceptible to varying interpretations. If, as is the case here, a taxpayer has no short-term capital losses, the "excess"—which constitutes the Section 1201 (b) (2) capital gains base upon which the flat 25 percent tax is computed—can only be the net long-term capital gains unreduced by any offset.

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[12] Strictly speaking, the quoted phrase is found only in Section 1201 (b) (2). However, both Sections 1201 (b) (1) and 1202 address the case where "the net long-term capital gain exceeds the net short-term capital loss," and use the term "such excess." Thus, all three provisions refer to the same quantitative "excess."

For petitioners to prevail, the statutory "excess" phrase would have to be given a unique meaning applicable only to the alternative tax computation, *i.e.*, "excess * * * reduced by the amount of such net long-term gain set aside for charity." Such a radical transformation of Section 1201(b)(2) hardly comports with this Court's oft-stated admonition that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses" (footnote omitted). *Crane* v. *Commissioner*, 331 U.S. 1, 6. See also *Malat* v. *Riddell*, 383 U.S. 569, 571; *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 687-688; *Commissioner* v. *Korell*, 339 U.S. 619, 627-628; *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 740-741.

Indeed, only two Terms ago in *United States* v. *Foster Lumber Co.*, 429 U.S. 32, the Court rejected a similar attempt by a taxpayer to depart from the plain meaning of a tax statute and impose a special gloss with respect to the alternative capital gains tax computation. There, the question was to what extent a loss carryback was "absorbed" in a prior year in which the alternative method was applicable. The pertinent statute, Section 172(b)(2), provided that the amount of the loss carryback available for use in future years was "the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried." Since Section 63(a) defines the term "taxable income" to include both ordinary income and capital gains, the Court concluded that the "excess" in Section 172(b)(2) was the amount of the carryback over the sum of ordinary income *and* capital gains, and not simply ordinary income, as the taxpayer urged. In so holding, the Court stated, in terms that apply with equal force here (429 U.S. at 41):

> It is, of course, not unusual in statutory construction to find that a defined term's meaning is substantially modified by an attached clause. But reading "taxable income to which . . . such loss may be carried" as equivalent to "taxable income to which such loss may be carried and deducted, resulting in a reduction of tax liability" gives these phrases a synergistic effect that goes well beyond their natural import. Such a construction subtly redefines "taxable income" in terms of the tax impact of a particular method of tax calculation. It thus implicitly departs from the "term of art" definition of taxable income given in § 63(a), while discovering a significance in the word "carry" that goes well beyond its usual connotation of a transfer of a loss from the year in which it occurred. * * * If Congress had intended to allow a loss deduction to offset only ordinary income when the alternative tax calculation method is used, it could easily have said so.

The reasoning of *Foster Lumber Co.* should govern this case. Just as the Court refused to redefine "taxable income" to accommodate the special needs of a taxpayer required to employ the alternative tax com-

putation, it should likewise refuse to cumulate the benefits of the alternative tax and the ordinary income deductions by interpolating a charitable contribution deduction into the statutory phrase "excess of the net long-term capital gain over the net short-term capital loss." "Since the statutory language seems rather plain in both * * * [Sections 1202 and 1201(b)], * * * [the courts] have the same duty in both to resist the temptations to attempt any creative rewriting of the Internal Revenue Code." *United States* v. *Foster Lumber Co., supra*, 429 U.S. at 49 (Stevens, J., concurring). Surely if Congress had intended to allow a deduction from the Section 1201(b)(2) capital gains base for the amount of such gains set aside for charity, it could easily have so provided in plain unmistakable terms.

c. Finally, the structure of Section 1201(b) refutes petitioners' claimed reduction of the capital gains base by the amount of such gains set aside for charity. As we have pointed out *supra*, pp. 18-19, the partial tax base of Section 1201(b)(1) is computed by subtracting 50 percent of the net long-term capital gains from "taxable income" so as to isolate the net ordinary income subject to the graduated rates. But "taxable income," as defined by Section 63(a), is "gross income, minus the deductions alowed by this chapter * * *." Hence, the partial tax base already reflects the deduction for amounts set aside for charity, as well as all other allowable deductions.

In contrast, however, the capital gains base is "the excess of the net long-term capital gain over the net

short-term capital loss." Thus, the statutory scheme allocates all of the allowable deductions to the Section 1201(b)(1) ordinary income partial tax base and none to the Section 1201(b)(2) capital gains base. As a result, there is no justification for shifting deductions from the partial tax base to the capital gains base simply because those deductions may be "wasted" to the extent they exceed the taxpayer's gross ordinary income (see Pet. App. 8). Indeed, the Court rejected much the same claim by the taxpayer in *Foster Lumber Co.* that the loss carryover deduction should not be "wasted" in the context of the alternative tax computation, observing that "Congress has not hesitated in this area to limit taxpayers to the enjoyment of one tax benefit even though it could have made them eligible for two " (429 U.S. at 45-46).

Here, the alternative flat rate on the capital gains base is a benefit that stands on its own independent footing and cannot be cumulated with the deduction for charitable contributions that comes into play only when the ordinary tax rates are applicable. As the dissenting judge in *Statler Trust* v. *Commissioner*, *supra*, 361 F.2d at 133, aptly stated: "The statute's effect is too plain to be supposed an inadvertent one, and it is far from being ungenerous. The alternatives are payment of tax at ordinary rates on half the capital gain less the adjusted deduction for the part of it paid to charity or paying a tax on that same income amount equal to a quarter of the total capital gain."

2. *The legislative history*

a. The legislative history confirms that Congress intended the statutory phrase "excess of the net long-term capital gain over the net short-term capital loss" to mean precisely what it says, *viz.*, the entire amount of long-term capital gain unreduced by amounts that might otherwise be allowable as offsets against ordinary income.

Prior to the Revenue Act of 1921, 42 Stat. 227, capital gains were taxed in the same manner as other income. However, in 1921, Congress introduced the capital gain concept and an alternative method of computing tax on capital gain for individuals at the election of the taxpayer. That method, essentially identical to the alternative computation provided by Section 1201 of the present Code, prescribed a partial tax on net ordinary income (net income exclusive of capital gain) computed at regular progressive rates, plus 12½ percent of "capital net gain," which was defined as the excess of capital gain over capital deductions and losses. See Revenue Act of 1921, Sections 206(a)(4) and (5) and 206(b). But in Section 208(a)(5) of the Revenue Act of 1924, 43 Stat. 262, the term "capital net gain" was redefined to mean—

> the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) *the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain* * * *. [Emphasis supplied.]

The purpose of this amendment was to provide relief for taxpayers whose deductions exceeded their ordinary income but whose capital gains would still be fully subject to the flat 12½ percent tax. The Act therefore permitted the offset of such excess deductions against the capital gains base. As the House Committee (H.R. Rep. No. 179, 68th Cong., 1st Sess. 19 (1924)) explained—

> Under the existing law the tax under the capital gain section is the tax on the ordinary net income plus 12½ percent of the capital gain. If the taxpayer has no ordinary net income but has a deficit, the tax under the existing law is still 12½ percent of the capital gain, although the capital gain may thus be in excess of the net income of the taxpayer. In the bill paragraph (4) is inserted, and the two succeeding paragraphs are changed in order to revise the definition of capital net gain so that *the tax in cases where there is a deficit in ordinary income will be 12½ percent of an amount determined by subtracting from the capital net gain the amount of the deficit in ordinary net income. This provision is in the interest of the taxpayer.* [Emphasis supplied.]

The identical provision was reenacted by Section 208(a)(5) of the 1926 Act, 44 Stat. 19, and by Section 101(c)(5) of the 1928 and 1932 Act, 45 Stat. 811 and 47 Stat. 191. The Revenue Act of 1934, however, eliminated the alternative tax on capital gains. Section 117(a) of that Act, 48 Stat. 714, instead pro-

vided that certain percentages [13] of the gain or loss recognized upon the sale or exchange of a capital asset "shall be taken into account in computing net income." Thus, under the 1934 Act (and the 1936 Act as well), the appropriate percentages of capital gain were included in gross income from which deductions were subtracted in determining net income. The tax was levied on the resulting figure at the regular graduated rates. Under these statutes, the taxpayer's deductions could be used to reduce that portion of the capital gain that was taken into account in determining gross income.

Section 117(b) of the Revenue Act of 1938, 52 Stat. 501, continued the inclusion of varying percentages of capital gains on gross income offset by the allowable deductions. However, Section 117(c) of that Act reintroduced the alternative tax in a different form that is the direct predecessor of Section 1201 of the present Code. Section 117(c)(1) of the 1938 Act provided (emphasis supplied):

> A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax *plus 30 per centum of the net long-term capital gain.*

Section 117(a)(8) of the Act defined the term "net long-term capital gain" as "the excess of long-term

[13] The percentages ranged from 100 percent, if the capital asset had been held for not more than one year, to 30 percent if held for more than 10 years.

capital gains for the taxable year over the long-term capital losses for such year."

Thus, unlike the alternative tax of the Revenue Act of 1924, which permitted the excess of ordinary deductions over ordinary income to be offset against capital gains, the 1938 Act did not permit any offset against capital gains by the excess "unused" ordinary deductions. To the contrary, it redefined the capital gains base as the total long-term capital gains minus the long-term capital losses without any further offset, thereby insuring that the total alternative tax would be "computed on the net income of the taxpayer exclusive of such long-term capital gain, at the regular rates, plus 30 per cent of the net long-term capital gain." H.R. Rep. No. 2330, 75th Cong., 3d Sess. 43 (1938).

This method of computing the alternative tax was carried forward in Section 117(c) of the 1939 Code and in Section 1201 of the 1954 Code. As the House Committee reporting out the current measure explained, "[t]his section is derived from section 117(c) of present law which provides the alternative tax on capital gains. No substantive change is intended although several wording changes have been adopted for simplification. The computation of the alternative tax is described in two steps rather than three." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A273 (1954). See also S. Rep. No. 1622, 83d Cong., 2d Sess. 431 (1954).

The foregoing legislative history convincingly refutes petitioners' claim to an offset from their net

capital gains in the amount of such gains set aside for charity. When Congress reintroduced the alternative tax in 1938, it changed the law from the 1924 version by broadening the capital gains base to include the total net long-term capital gains unreduced by any deductions otherwise allowable against ordinary income. The legislative evidence therefore clearly establishes that in 1924 Congress accepted but since 1938 has deliberately rejected the computational method urged by petitioners in this case. There is accordingly no basis for engrafting the once-applicable provisions of the Revenue Act of 1924 back onto the present statute when both the language and history point decisively in the opposite direction.

b. Our reading of the legislative history of Section 1201 is supported by all of the courts that have considered it. In *Weil* v. *Commissioner*, *supra*, an individual taxpayer's statutory deductions, including, *inter alia*, charitable contributions, exceeded his ordinary income, as distinguished from taxable capital gain. Like petitioners, the taxpayer in *Weil* claimed that his unused deductions (*i.e.*, the deficit in ordinary income) could be deducted from the taxable capital gain in computing the capital gain portion of the alternative tax. However, after considering the above-described legislative history, both the Tax Court (in a unanimous reviewed decision) and the Sixth Circuit concluded that the capital gain portion of the alternative tax under Section 117(c) of the 1939 Code is a flat rate of tax upon the total capital gains

unreduced by the amount of unused deductions. As the Tax Court observed (23 T.C. at 430-431):

> We thus believe that Congress intended that the 50 per cent rate be applied to the same amount in computing the capital gain portion of the alternative tax as was included in gross income in computing the regular tax. This express language of the statute carries out the intention of the framers of the 1938 Act * * * that a flat rate of tax on taxable capital gain be an alternative to the tax imposed upon such gain when it is included in gross income and taxed in the regular manner. Petitioners have not pointed out, and we are unable to find, anything in the language of the Code to indicate that Congress intended to include one amount in gross income for the regular tax computation but to apply the flat 50 per cent rate to some other amount under the alternative tax.[14]

See also Rev. Rul. 56-247, 1956-1 Cum. Bull. 383.

Moreover, in *Chartier Real Estate Co.* v. *Commissioner*, *supra*, the Tax Court reaffirmed its holding in

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[14] Although the flat rate on net capital gains is 25 percent under Section 1201(b) of the 1954 Code for the years involved here, as contrasted with the 50 percent rate under Section 117(c)(2) of the 1939 Code applicable in *Weil*, the result would be the same under either statute. Under Section 1201(b), the 25 percent rate is applied to the entire excess of net long-term capital gain over net short-term capital loss, while under Section 117(c)(2) of the 1939 Code (as it stood in 1948, the year involved in *Weil*), only 50 percent of the capital gain was taken into account for this purpose. In *Weil*, the Tax Court noted the variant statutory mechanisms (23 T.C. at 431 n. 1).

Weil and applied it to the essentially identical alternative tax for corporations provided by Section 1201 (a) of the 1954 Code. There, as here, the taxpayer sought to offset its net capital gains against a deficit in ordinary income. But Judge Raum found no basis in the language of the statute for such an offset, observing that "[w]e refused in *Weil* to engraft such a limitation onto the plain words of the statute, and we refuse to do so here" (52 T.C. at 352). Moreover, the court adhered to its prior analysis of the legislative history. "The conclusion drawn from this history in *Weil* and here is that since the 1924 Act specifically provided for the application of a deficit in ordinary income to capital gain in computing the capital gains portion of the tax, the absence of such a provision in the 1939 and 1954 Codes is of significance and prevents our reading in such a provision, for Congress knew how to deal with the problem when it wished to" (*id.* at 353). See also *United States* v. *Foster Lumber Co.*, *supra*, 429 U.S. at 38 and and n. 5, 47 and n. 17, 49 and n. 2 (Blackmun, J., dissenting); *Pope & Talbot, Inc.* v. *Commissioner*, 60 T.C. 74, affirmed *per curiam*, 515 F.2d 155 (C.A. 9).

B. There is no exception for estates or trusts from the rule of Section 1201(b) that net long-term capital gains are subject to tax without reduction for amounts set set aside for charity

1. a. Petitioners do not dispute that the language of Section 1201(b) and its legislative history preclude a reduction in the capital gains base by the amount of

such gains set aside for charity. Nevertheless, they premise their claim to such an offset entirely on the ground that an estate rather than an individual earned the capital gains in question, and that estates are subject to special rules that override the otherwise applicable requirements of the alternative tax computation. In petitioners' view, the Code considers the Disney Estate as a "conduit" with respect to the portion of its capital gains set aside for charity, and that from the very outset such gains are attributable to the charitable beneficiaries and not to the estate. Petitioners urge that under the conduit rule, the estate never "owned" the gains it set aside for charity so that such amounts are properly excludable from its tax base. They would therefore simply eliminate the capital gains set aside for charity from both steps of the alternative computation. In support of their argument, petitioners principally rely upon *Statler Trust* v. *Commissioner*, *supra*. There, the Second Circuit employed a "conduit" rationale and held that a trust could reduce its Section 1201(b) capital gains base by the amount of such gains set aside for charity.[15]

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[15] Petitioners argue (Br. 12-13) that Congress "must be deemed to have approved and adopted the Second Circuit's decision * * *" because Congress has twice amended both Sections 642(c) and 1201(b) since that decision. But the doctrine of legislative reenactment upon which petitioners rely requires a settled judicial construction of a statute, not a single lower court decision. At all events, there is no evidence that Congress ever addressed the *Statler Trust* decision.

But petitioners' claim that charitable "set asides" are subject to "conduit" tax treatment so that an estate need not include such amounts in income does not withstand careful scrutiny of the pertinent provisions of Subchapter J (Sections 641-691) of the Code. Under the system of taxation established by the 1954 Code, estates and trusts are generally regarded as conduits through which income flows to the beneficiaries; they are considered to be separate taxable entities only to the extent that they accumulate income for future distribution. The estate receives a deduction for amounts of income and any other amounts required to be distributed currently (Section 661), and the amounts so distributed are in turn includable in the gross income of the beneficiaries (Section 662). See generally *Freuler* v. *Helvering*, 291 U.S. 35, 41-42.

In order to implement this new system, Congress introduced the concept of "distributable net income" to serve as the ceiling of the estate's distribution deduction and the amount upon which the beneficiaries may be taxed and to determine the character of amounts distributed to the beneficiaries. Thus, Section 643(a) defines "distributable net income" as "taxable income" with certain adjustments (such as inclusion of tax-exempt interest) in order to permit the taxation of beneficiaries with respect to items that would not be includable in the estate's gross income but which may be available for distribution to the beneficiaries. In turn, the beneficiaries are entitled to

claim the benefits of statutory exclusions applicable to the proportionate share of their distribution deemed to retain the character of tax-exempt income. Section 662(b). See generally S. Rep. No. 1622, *supra*, at 343-345.

The fundamental error in petitioners' position and that of the Second Circuit in *Statler Trust* is the assumption that capital gains set aside by an estate for charity are subject to the conduit rules of Sections 661 and 662. To the contrary, Section 663(a)(2) explicitly provides a special rule that amounts qualifying for the charitable deduction are not to be taken into account in computing an estate's distribution deduction (Section 661(a)) and the amount required to be reported by the beneficiaries as distributable income (Section 662(a)). The special rule of Section 663(a)(2) states: "There shall not be included as amounts falling within section 661(a) or 662(a)— * * * (2) * * * Any amount paid or permanently set aside or otherwise qualifying for the [charitable] deduction provided in section 642(c) * * *." Thus, Congress undisputedly placed such charitable set-asides outside the ambit of the conduit rules pursuant to which the estate deducts and the beneficiaries include in gross income all income required to be distributed currently. As the Senate Finance Committeed observed with respect to the special rule of Section 663(a)(2), "[s]ince the estate or trust is allowed a deduction under Section 642(c) for amounts paid, permanently set aside, or otherwise qualifying for the

deduction provided in that section, such amounts are not allowed as an additional deduction for distributions, nor are they treated as amounts distributed for purposes of section 662 in determining the amounts includible in gross income of the beneficiaries." S. Rep. No. 1622, *supra*, at 354.[16]

Moreover, the fact that Section 642(c) allows an estate or trust a deduction from gross income for amounts set aside for charity shows that Congress classified amounts of income paid by an estate or trust to charity as belonging to the estate or trust in the first instance and not to the charitable beneficiary. Thus, contrary to petitioners' contention (Pet. 17-18 n. 14), the availability of a statutory charitable deduction from the gross income of a trust or estate means that the deductible item is *not* within the conduit rules. Only those items that are deductible as distributions under Sections 651 and 661 are subject

[16] The Second Circuit in *Statler Trust* refused to regard Section 663(a)(2) as evidence of Congress' intention to classify charitable contributions outside the operation of the conduit rules. In its view, Section 642(c) provides for a special unlimited charitable deduction applicable to trusts and "Congress enacted § 663(a)(2) to prevent the trust from having a double deduction and a beneficiary from claiming a charitable deduction already taken by the trust" (361 F.2d at 132). But this point does not detract from our argument that Section 663(a)(2) places charitable set asides outside the conduit rules. Taken together, Sections 642(c) and 663(a)(2) show that Congress chose to regard the charitable set aside as a charitable rather than as a distribution deduction of the trust. Thus, the capital gains that are the subject of the charitable set aside are attributable to the trust and not the beneficiary.

to conduit treatment. Petitioners therefore err in arguing (Br. 15-18) that Section 642(c) manifests a conduit principle with respect to charitable contributions. That provision simply permits the trust or estate a deduction against its own income—a treatment under the Code directly contrary to that of a conduit. Unlike Section 661, it does not treat charitable contributions as distributions already in the hands of the recipients, and unlike Section 662, it does not deem such amounts as received by the charity.[17]

b. Acknowledging that Section 663(a)(2) presents a formidable statutory obstacle to their argument that capital gains set aside by an estate for charity are subject to the conduit rules, petitioners contend (Br. 17-18), in accordance with the Second Circuit's observation in *Statler Trust*, that "Congress considered charitable contributions from capital gains to be generally within the conduit principle, as demonstrated by their inclusion in the definition of distributable net income in § 643(a)(3)" (footnote omitted) (361 F.2d at 131). Section 643(a)(3), the provision to which the court referred, includes in the distributable net income of an estate or trust capital

[17] There have been proposals, which, if enacted, would have treated charitable contributions as *distributions* by the estate. See Sections 102(b), 103, 106, 107 and 108(a) of H.R. 9662, 86th Cong., 2d Sess. (1960); H.R. Rep. No. 1231, 86th Cong., 2d Sess. 10 (1960). The bill provided for repeal of the Section 642(c) charitable deduction, and proposed to replace it with a mechanism under which such amounts would be treated as distributions.

gains set aside for charity. See Treasury Regulations, Section 1.643(a)-3(a) (26 C.F.R.).

But the inclusion of such gains in distributable net income does not establish that they are subject to the conduit rules of Sections 661 and 662. The add-back provisions of Section 643(a)(3) are one of a series of modifications to the taxable income of an estate or trust to arrive at "distributable net income." See Section 643(a)(1) through (7). Since the concept of distributable net income is used to determine the maximum amount upon which the beneficiaries can be taxed, it was "necessary to adjust the taxable income of an estate or trust by adding to it items of trust income which are not includible in the gross income of the estate or trust but which may nevertheless be available for distribution to the beneficiaries." S. Rep. No. 1622, *supra*, at 343. Section 643(a)(3) therefore includes the capital gains set aside for charity in distributable net income in order to prevent a non-charitable beneficiary from deriving an advantage from the estate's charitable deduction. Absent the add-back provisions of Section 643(a)(3), the estate's distributable net income would not include the capital gains set aside for charity and would therefore enable the current income beneficiaries to receive tax-free distributions from the estate to the extent of the amount of those gains.[18] Thus, contrary to the view

[18] This point can be demonstrated by the following example. Suppose an estate has ordinary gross income of $60,000 and net long-term capital gains of $40,000. Pursuant to the will, the entire $40,000 is distributed to charity. Under Section 643(a), distributable net income is $100,000 ($60,000 ordinary income + $40,000 capital gains — $40,000 charitable contribution + $40,000 capital gains add-back). Thus, if the estate distributed $100,000 to its current income beneficiaries Section 643(a)(3) insures that they will be taxable on the full distribution despite the fact that the estate's taxable income was $60,000. The effect of the capital gains "add-back" is to prevent the current income beneficiaries from taking advantage of the estate's charitable deduction by limiting their taxable distribution to $60,000.

of the Second Circuit in *Statler Trust*, the purpose of Section 643(a)(3) was not to include an estate's charitable payments within the conduit principle but to deny the benefits of the charitable contribution deduction to the current income beneficiaries of the estate. Section 643(a)(3) therefore provides no support for petitioners' claimed offset against their capital gains base. As the court below properly concluded, "[t]he [*Statler Trust*] court's reliance on section 643(a)(3)'s inclusion of charitable payments and set asides from capital gains in distributable net income to evidence a pervasive reliance on a conduit principle for such charitable provisions is misplaced. Section 643(a)(3) * * * is part of a structure which in its entirety unmistakably rejects the conduit principle for charitable payments and set asides" (Pet. App. 15).[19]

[19] Contrary to the assumption of the Second Circuit in *Statler Trust* (361 F.2d at 131), the statutory rules are different for capital gains set aside for non-charitable beneficiaries. In that case, the gains are subject to conduit treatment. The second sentence of Section 1202 requires that such gains be included in the income of the recipient beneficiary under Sections 652 and 662, and the beneficiary is entitled to claim the

Finally, there is other statutory evidence that Congress intended to exclude charitable beneficiaries from the conduit structure. Section 662(a)(1) provides that current income beneficiaries must compute distributable net income without regard to the trust's charitable deduction (and thereby increase their tax base) whenever amounts of income required to be distributed currently exceed distributable net income as so computed. By eliminating the charitable deduction from the computation of distributable net income for this purpose, the Code refutes petitioners' claim that the capital gain set aside for charity should simply not be considered. See Treasury Regulations, Section 1.662(a)-2, particularly Section 1.662(a)-2(e), Exs. (1) and (2); S. Rep. No. 1622, *supra*, at 349. For if petitioners were correct in their assertion that capital gains set aside for charity should be eliminated from the estate's tax base, the estate would have had no charitable deduction for such gains and there would

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50 percent deduction of the Section 1202 normal tax computation. See Treasury Regulations, Section 1.1202-1(b). The trust would correspondingly treat the payment as a deductible distribution under Section 661. It is therefore clear that Congress carefully distinguished between capital gains set aside for charitable and non-charitable beneficiaries, and provided for conduit treatment only in the latter case. Indeed, petitioners' computation of the Disney Estate's normal tax implicitly recognizes that capital gains set aside for charity are not subject to conduit treatment since they claimed the Section 642(c) charitable deduction on behalf of the trust. See pp. 19-20, *supra*.

have been no need for Congress to have provided the special computational rule of Section 661(a)(1). Thus, Section 661(a)(1) cannot be reconciled with petitioners' attempt to remove capital gains set aside for charity on the basis of a conduit theory.[20]

2. Contrary to petitioners' further argument (Br. 25-27), the decisions permitting a deduction under Section 691(c) for estate taxes allocable to income in respect of a decedent against long-term capital gains do not support their claimed charitable contribution offset against their capital gains base. In those cases,[21] a decedent's estate earned capital gains upon the sale of capital assets. It included the value of the capital assets in the gross estate for estate tax purposes and also paid income tax upon the capital gains received from their sale. In computing its capital gains tax under the alternative method, it claimed a deduction

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[20] Section 662(a)(2) and (b) are also inconsistent with petitioners' exclusion of charitable set-asides from an estate's income. Under Section 662(a)(2), non-current income beneficiaries are entitled to take the trust's charitable deduction into account in computing distributable net income. Likewise, under Section 662(b), which provides an allocation formula for determining the character of amounts distributed to the beneficiaries, the charitable deduction is taken into account. See Treasury Regulations, Section 1.662(b)-2.

[21] See, *e.g.*, *Read* v. *United States*, 320 F.2d 550 (C.A. 5); *Meissner* v. *United States*, 364 F.2d 409 (Ct. Cl.); *Estate of Sidles* v. *Commissioner*, 65 T.C. 873, *acq.* 1976-2 Cum. Bull. 2. See also *Quick* v. *United States*, 503 F.2d 100 (C.A. 10); *Goodwin* v. *United States*, 458 F.2d 108 (Ct. Cl.).

under Section 691(c) from the Section 1201(b)(2) capital gains tax in the amount of estate tax attributable to the inclusion of the capital assets in the gross estate. Despite the fact that Section 1201(b)(2) does not literally permit a Section 691(c) deduction for estate taxes paid on income in respect of a decedent, the courts upheld the deduction. Petitioners urge that a similar departure from the terms of Section 1201(b) is required here.

But the decisions allowing a Section 691(c) deduction from the Section 1201(b) capital gains base turn on the particularized nature of the Section 691(c) deduction. As the Fifth Circuit in *Read* explained, the purpose of the Section 691(c) deduction is to prevent the imposition of estate tax and income tax on the full amount of the income claims of a decedent. For if the income had been received by the decedent prior to his death, the estate tax would be levied on the amount realized reduced by the income taxes attributable to it. See S. Rep. No. 1622, *supra*, at 87-89; H.R. Rep. No. 1337, *supra*, at 64-65. In the case of a decedent whose gross estate includes claims to income (income in respect of a decedent) upon which estate and income taxes must be paid, Section 691(c) permits a deduction for the estate tax attributable to the inclusion in the gross estate of the claims to income. Thus, in order to implement the congressional policy against double taxation, the courts have permitted the Section 691(c) deduction to come into play

in the alternative tax computation (see 320 F.2d at 553).

Here, however, there are no considerations of double taxation that would justify reduction of the capital gains base by the amount of the charitable contribution. As the court of appeals correctly observed, "[i]n holding as we do we do not subject capital gains to double taxation nor do we eliminate the effectiveness of the charitable contribution for estates and trusts. While we do preclude the reduction of the flat tax on capital gains in calculating the alternative tax by refusing to permit the capital gains to be reduced by amounts paid or permanently set aside to charity, we do so in accordance with both the letter and spirit of the applicable provisions of the Code" (Pet. App. 14). The Section 691(c) authorities are therefore distinguishable.[22]

3. Finally, as further support for its decision, the Second Circuit in *Statler Trust* observed that "[t]he increase in the tax due to including such distributable

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[22] Petitioners also argue (Br. 22) that a partial distribution of the securities in kind to the Foundation followed by the sale of the securities by the Foundation would have eliminated the controversy presented by this case. That is correct. Any gains would have been those of the Foundation and not of the estate. But analysis of the matter on this hypothetical basis "would require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred." *Commissioner* v. *Nat. Alfalfa Dehydrating*, 417 U.S. 134, 148. Accord: *Central Tablet Mfg. Co.* v. *United States*, 417 U.S. 673, 690; *Frank Lyon Co.* v. *United States*, No. 76-624, decided April 18, 1978, slip op. 14-15.

gains in computing the alternative tax would have to be borne by either the charities or the remaindermen" (361 F.2d at 132). In the court's view, either possibility would "lead to an unfair or unintended result" (*id.* at 131). If the charities received a lesser distribution there would be an indirect incursion on their exempt status; to place the burden on the remaindermen would subject them to a higher tax than if the settlor had not favored charities as income beneficiaries. The court therefore distinguished the *Weil* decision on the ground that there the taxpayers made charitable gifts of gains that they themselves realized during the year (*ibid.*).[23]

But as we have pointed out *supra*, pp. 38-41, the pertinent Code provisions demonstrate in unmistakable terms that Congress intended to deny current income beneficiaries the benefits of the deduction of an estate or trust arising from distributions of capital gains to charity. It has done so (1) by requiring in Section 643(a)(3) that capital gains set aside for charity be included in distributable net income so as to increase the tax base of the non-charitable beneficiaries; and (2) by providing in Section 662(a)(1) that the amount includable in the gross income of a current income beneficiary be computed without the

[23] Petitioners further suggest (Br. 13-14 n.12) that the fact that the charitable set aside was required by the terms of the will distinguishes this case from *Weil*, where the contributions were voluntary. Suffice it to say that the Code makes no distinction between required and voluntary charitable contributions.

trust's charitable deduction when the amount of income required to be distributed currently exceeds the trust's distributable net income plus the charitable contribution deduction. Thus, to the extent that Congress addressed the question, it made a conscious choice and refused to accord non-charitable current income beneficiaries the tax benefit from income distributions made by an estate or trust to charity. As the court of appeals concluded, "[w]e are aware, of course, that any computation that reduces taxes on taxable beneficiaries because of charitable payments or set asides is directly advantageous to such beneficiaries and indirectly helpful to charities generally. While such a consideration in an exquisitely balanced situation might be controlling, the case before us is not such a situation. To permit such concerns to control here is contrary to the statute as written" (Pet. App. 15).[24]

[24] Petitioners also argue (Br. 29-37) that the Commissioner's position precluding the reduction of the capital gains base by the amount of the charitable deduction will produce "absurd" tax consequences in certain cases. Specifically, petitioners cite an example (Br. 33-34) in which the estate's ordinary income is large enough to absorb one-half of the total net long-term capital gains. Under these circumstances, the Commissioner's method will yield a lower alternative tax than petitioners' method, which petitioners attribute (Br. 31) to "a cumulative deduction equal to 150 per cent of [the] capital gains in computing the 'partial tax' under § 1201(b)(1)" (footnote omitted).

However, the fact that a different result would follow if the estate's ordinary income is sufficient to absorb one-half of the total long-term capital gains does not cast doubt upon the correctness of our position. We do not dispute that Section 1201(b) gives significance to the relative quantities of ordi-

To be sure, as petitioners argue (Br. 28, 37) and the Second Circuit observed in *Statler Trust* (361 F.2d at 132), this Court noted in a different statutory context in *Helvering* v. *Bliss*, 293 U.S. 144, 150-151, that exemptions of income devoted to charity and the reduced capital gains rate were liberalizations in the law that were not to be narrowly construed. But the Court subsequently recognized that its generalized statement in *Bliss* could not serve as the basis of decision in a case where, as here, the plain words of the statute and its legislative history pointed in the opposite direction. In terms singularly appropriate to this case, the Court stated: "Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that ex-

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nary income, capital gains, and the amount of such gains set aside for charity. But in prescribing an alternative method for the computation of capital gains, Congress was free to cast that method in whatever terms it chose. Since the statute speaks of "the excess of the net long-term capital gain over the net short-term capital loss," that amount, unreduced by any offset, is available (to the extent of 50 percent) as a deduction in computing the partial tax and is fully subject to the flat tax. Indeed, petitioners' argument is essentially identical to the taxpayer's claim in *Foster Lumber Co.* that it should not be penalized as a result of the timing of its receipt of ordinary income and capital gains. In rejecting this contention on the basis of the plain words of the statute, the Court stated: "But if Congress were intent on substantially eliminating accidents of timing from the calculation of income on an average base, it would hardly have tolerated such a departure from that purpose at the very inception of the tax benefit provided by § 172" (429 U.S. at 47).

press limitations on such an exemption are to be ignored." *Better Business Bureau* v. *United States*, 326 U.S. 279, 283. See also *Commissioner* v. *Gordon*, 391 U.S. 83, 93.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1964 ed.)):

SECTION 642. Special rules for credits and deductions.

* * * *

(c) Deduction for amounts paid or permanently set aside for a charitable purpose.

In the case of an estate or trust (other than a trust meeting the specifications of subpart B) there shall be allowed as a deduction in computing its taxable income (in lieu of the deductions allowed by section 170 (a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for a purpose specified in section 170 (c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. For this purpose, to the extent that such amount consists of gain from the sale or exchange of capital assets held for more than 6 months, proper adjustment of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the estate or trust under section 1202 (relating to deduction for excess of capital gains over capital losses). In the case of a trust, the

deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income and prohibited transactions).

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SECTION 643. Definitions applicable to subparts A, B, C, and D.

(a) Distributable net income.

For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) Deduction for distributions.

No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) Deduction for personal exemption.

No deduction shall be taken under section 642 (b) (relating to deduction for personal exemptions).

(3) Capital gains and losses.

Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642 (c). Losses from the sale or exchange or capital assets shall be excluded,

except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(4) Extraordinary dividends and taxable stock dividends.

For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason to his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) Tax-exempt interest.

There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) Income of foreign trust.

In the case of a foreign trust—

(A) There shall be included the amounts of gross income from sources

without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(1) (relating to disallowance of certain deductions).

(B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).

(C) Paragraph (3) shall not apply to a foreign trust created by a United States person. In the case of a such a trust, (i) there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and (ii) the deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(7) Dividends.

There shall be included the amount of any dividends excluded from gross income pursuant to section 116 (relating to partial exclusion of dividends received).

If the estate or trust is allowed a deduction under section 642 (c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642 (c) is deemed to consist of items specified in those

paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

* * * *

SECTION 661. Deduction for estates and trusts accumulating income or distributing corpus.

(a) Deduction.

In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—

(1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and

(2) any other amounts properly paid or credited or required to be distributed for such taxable year;

but such deduction shall not exceed the distributable net income of the estate or trust.

* * * *

SECTION 662. Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus.

(a) *Inclusion.*—subject to subsection (b), there shall be included in the gross income of

a beneficiary to whom an amount specified in section 661(a) is paid, credited, or required to be distributed (by an estate or trust described in section 661), the sum of the following amounts:

(1) *Amounts required to be distributed currently.*—The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642(c), relating to deduction for charitable etc. purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

(2) *Other amounts distributed.*—All other amounts properly paid credited, or required to be distributed to such beneficiary for the taxable year. If the sum of—

(A) the amount of income for the taxable year required to be distributed currently to all beneficiaries, and

(B) all other amounts properly paid, credited, or required to be distributed to all beneficiaries

exceeds the distributable net income of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (reduced by the amounts specified in (A)) as the other amounts properly paid, credited or required to be distributed to the beneficiary bear to the other amounts rpoperly paid, credited, or required to be distributed to all beneficiaries.

(b) *Character of Amounts.*—The amounts determined under subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the

items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

SECTION 663. Special rules applicable to sections 661 and 662.

(a) Exclusions.

There shall not be included as amounts falling within section 661 (a) or 662 (a)—

* * * *

(2) Charitable, etc., distributions.

Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642 (c) (computed without regard to section 681).

* * * *

SECTION 1201. Alternative tax.

* * * *

(b) Other taxpayers.

If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

* * * *

SECTION 1202. Deduction for capital gains.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

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